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Hearing before Senate Committee on Aging
Strengthening Social Security: Can We Learn From Other Nations?"
May 18, 2004

Thank you Mr. Chairman and Members of the Committee for inviting me to testify today about strengthening Social Security and what we can learn from experiences in other nations. Learning from other countries is one of the reasons Social Security is actively involved in three international social security organizations.

I also want to thank you again, Mr. Chairman for hosting a series of events last month in Idaho during which we discussed Social Security's future. Achieving "Sustainable Solvency" is one of the Social Security Administration's four strategic goals.

As President Bush and many of his predecessors have said, Social Security has been one of the most successful government programs. Social Security is the foundation of well being for the elderly, the disabled and their families. This may be why in a poll conducted by the National Archives, the Social Security Act was recently voted one of the ten most important documents in American history, sharing that distinction with the Declaration of Independence and the Constitution among others. The Social Security Act and the Civil Rights Act were the only two pieces of legislation selected.

Social Security continues to be one of the most successful government programs. Last year SSA paid over $470 billion in benefits to 47 million retirees, survivors, and disabled individuals and their dependents. Social Security is much more than a retirement program. Thirty percent of our beneficiaries are disabled or survivors -- widows, widowers and children. Nearly 157 million American workers paid Social Security taxes last year. They, their families, and the millions joining the system every year, are relying on Social Security for a major portion of their future financial security.

Hearings like this, events like those in Idaho and reform lessons learned from other countries will help create a bipartisan consensus for reforms to keep Social Security successful for future generations.

In my testimony I will review the Social Security program's financing and discuss the long-range status of the trust funds, particularly in terms of the changing demographics that will have a major impact on the program. I will also discuss how many other nations face similar demographic issues and how some of those nations implemented reforms in their social insurance programs to address those issues. Finally, I will discuss what lessons can be learned from the foreign experience.

It is important to keep in mind that every country has its own unique circumstances and that what works best in one country may not be the best solution for the United States. However, there is a good deal of valuable information that can be obtained from examining the efforts to reform social insurance programs around the globe.

Social Security Financing

The American Social Security program is financed primarily through payroll taxes. Workers in covered employment, their employers, and self-employed people are taxed on earnings up to an annual maximum amount. The maximum amount, $87,900 for 2004, increases automatically in proportion to increases in average covered wages. The combined employee-employer tax rate is 12.4 percent of earnings.

Social Security is financed on a pay-as-you-go basis, under which most of the Social Security taxes paid by workers are immediately paid out in benefits. Trust fund reserves serve as a contingency when program outgo exceeds income. By law, trust fund assets that are not immediately needed to pay benefits are invested in special securities of the United States Treasury. These securities earn interest which is paid in the form of special issue Treasury bonds.

Status of the Trust Funds

Social Security's trust funds grew by over $150 billion to $1.5 trillion last year. Over half this growth was from interest on the trust funds. But today Social Security faces serious long-range financing issues. Under the 2004 Trustees Report's intermediate assumptions, it is projected that Social Security trust fund assets will be exhausted in 2042. At that point, just prior to my two children's retirements, the incoming payroll taxes would cover only about 73 percent of scheduled benefits.

More importantly, the Trustees point out that pressure on the trust funds will begin in 2008, when the first Baby Boomers reach early retirement age. Beginning in 2018, the trust funds are projected to begin paying out more in benefits than is collected in payroll taxes. At that time, in order to pay benefits, the program will begin to rely on trust fund interest income and redemption of government bonds, which will put pressure on government finances. So as you can see, the financing challenges faced by the program need to be addressed sooner rather than later.

As the Trustees said in their 2004 report, "The projected trust fund deficits should be addressed in a timely way to allow for a gradual phasing in of the necessary changes and to provide advance notice to workers. The sooner adjustments are made the smaller and less abrupt they will have to be." For example, the changes enacted to increase the retirement age in 1983 started last year -- 20 years later -- and will phase in over several decades. Early action will also allow current workers plenty of time to properly plan for their retirement.

Demographic Factors

The reason Social Security is unsustainable under current law is very simple – the aging of America. People are living longer, the birth rate is low and the first Baby Boomers will be eligible to retire in 4 years. This combination means that the growth in the number of beneficiaries will begin to greatly exceed the growth of workers. The ratio of workers to beneficiaries which includes retirees, disabled workers, survivors and dependents, has fallen from 8 to 1 in 1955 to 3.3 to 1 today. Most of the Baby Boom generation will be retired by 2030, and the projected ratio of workers to beneficiaries will be only 2.2 to 1 at that time. Thereafter, the number of workers to beneficiaries will slowly decline, and Social Security's projected costs will continue to increase.

Looking just at retirees, the attached chart shows that in 1995 the ratio of workers to pensioners was well over 2 to 1 in most of the developed countries. By 2050, this ratio is projected to fall dramatically to unsustainable levels in most of these countries. And in one country – Italy – it will sink beneath 1 to 1, meaning that more people will be collecting benefits than paying taxes.

As these data show, the world stands on the threshold of a great demographic sea change – global aging. Just yesterday, the Social Security Administration sponsored a conference on global aging with some of the leading experts on the subject. We are also now publishing a monthly newsletter of happenings in the international social security world.

There are two forces behind global aging. The first force is falling fertility rates -- people are having fewer babies, decreasing the relative number of younger people in the population. The second force behind global aging is rising life expectancy. People are living longer, thus enlarging the relative number of older people in the population.

Global aging is at different stages in different countries. As shown in the chart, the issue for Europe and Japan is more advanced than the United States. We are cushioned by higher birth rates and higher immigration levels than those countries but we still face the challenge of an aging population. Also, due to the 1983 reforms, Social Security has one of the highest retirement ages, as we move the full benefit retirement age to 67.

For these reasons, the United States is in a somewhat better position to begin to deal with the challenges presented by our changing population than are many other nations. It is sometimes difficult to make direct comparisons with what other countries are doing or have already done because other countries have different income support and private sector pension programs. Nonetheless, examination of the experience of foreign countries provides interesting and valuable insights, and there is much we can learn.

Reforms in Selected Countries

Although Social Security reforms throughout the world have been complex and ever evolving, there are basically three major categories of reform:

- increasing taxes
- decreasing scheduled benefits
- increasing investment returns

The first two are the traditional reforms. The Social Security payroll tax rate has been raised 19 times and the 1983 increase in the retirement age was a reduction in scheduled lifetime benefits. As a country gets closer to a crisis, raising taxes or reducing benefits are the only choices.

Many countries have decided to plan ahead by prefunding future social security payments and investing those funds in private sector securities to increase returns. In some countries, such as Canada, that has meant direct investment by the trust funds in private sector securities. In others, it has meant establishing personal accounts.

President Bush, in his State of the Union address this year, once again called for personal accounts for younger generations when he said, "Younger workers should have the opportunity to build a nest egg by saving part of their Social Security taxes in a personal retirement account. We should make the Social Security system a source of ownership for the American people."

About 30 countries have implemented some type of personal account system as a component of their mandatory retirement insurance program. In addition, several other countries have recently passed legislation or are considering reforms that include personal accounts.

Now I would like to talk briefly now about the experiences of six specific countries that have implemented reforms to their systems. These countries are the United Kingdom, Chile, Australia, Sweden, Japan, and Germany.

United Kingdom

Let me begin with the United Kingdom as they began reforms in 1980, which I remember well as I was working there at the time. The United Kingdom offers a system comprised of two compulsory tiers. The first tier provides a flat-rate benefit prorated according to years of contributions. The second tier is an earnings-related benefit in the form of a public, occupational, or personal pension. Workers may opt out of the public pension by participating in either an occupational pension provided by the employer or in a personal pension plan financed by rebates of the employee and employer contributions to the public system. These last two options use investments in private sector markets to fund retirement.

The late 1980s saw an expansion of approved options for personal account plans and the government actively encouraged workers to opt out of the public system. However, a series of scandals in the "mis-selling" of these pension products and the abuse of a prominent company's pension plan led to legislation to increase government regulation and oversight. In addition, other reforms were enacted to restructure the second tier and tighten regulations and oversight of the pension industry. These reforms have increased participation in personal pensions by low wage workers by providing greater investment options while capping administrative fees. This year, the United Kingdom is continuing its reform effort with significant new legislation to modify and strengthen its social security and pension plans.

Chile

In 1981, Chile was the first country to totally replace a pay-as-you-go system with a personal account approach. Under the Chilean model, each worker contributes 10 percent of their wages each month to a personal account in a pension fund management company plus an additional 2.6 percent for administrative fees and disability and survivors insurance. The employer makes no contributions. The plan is based on personal retirement accounts administered by private pension fund management companies, licensed and regulated by the Chilean government. At retirement, the benefit is equal to the insured's contributions plus investment returns, less administrative fees. The government guarantees a minimum pension to those with 20 years of contributions whose account balance is insufficient to fund a minimum benefit, which could create a financial burden for the Chilean government.

As the first country to transition from a pay-as-you-go system to a system based upon a personal account approach, Chile has had to resolve many new issues with regard to social insurance policy. The government was able to fund much of the transition investment by selling off a vast array of nationalized companies and issuing "recognition" bonds. Over the past two decades a number of changes have been made in the Chilean system in an effort to address these issues and develop a viable and sustainable retirement income program. Improvements have been made in the number of workers enrolled in the system, the number and type of investment choices, and in the regulation of the annuities market. Overall the reforms have been successful, but concerns remain about relatively high administrative costs, participation rates and improving worker's knowledge of the system.

Australia

In 1993, in recognition of the demographic changes, the Australian retirement system was reformed. Australia provides a two-pillar system. The first pillar is a means-tested program known as the Age Pension which is financed by general revenues. The second pillar, called the Superannuation Guarantee, requires employers to contribute on behalf of their employees to privately managed funds. Employers make contributions to these funds at the rate of nine percent of employee earnings and some employers make contributions that are above what is required. Benefits may be paid out as early as age 55, either as an annuity or as a lump sum.

Thus, Australia has approached the problem of improving retirement income not by expanding public programs, but by imposing a mandate on all employers to offer at least one contributory retirement plan to all employees. The accounts are intended to be portable and are managed by the private sector. However, because the accounts are provided on an individual employer basis with the fund selected by the employer, there are over 277,600 different funds, 99 percent of which are very small.

Sweden

Sweden began seeing the need for pension reform in the mid-1980s. Yet, 15 years passed from the time a commission was formed to study their pension system to the time reforms were implemented. The new system, begun in 1999, included the creation of a mandatory, fiscally sustainable, public system tied to economic growth. The Swedish model consists of their traditional social security program which will gradually be replaced by notional defined contribution (NDC) accounts as the first pillar. These non-funded accounts are a variant of a traditional earnings-related pension in which a hypothetical account is created for each insured person, with the account containing all the contributions during his or her working life. A pension is calculated based on average life expectancy and various economic factors. The annual contributions to the NDC are used to finance current pension obligations on a pay-as-you-go basis, but the account balances grow with annual contributions and the rate of return credited.

The second pillar is a mandatory personal account called the Premium Pension plan. Both employers and employees contribute equally to the NDC account and Premium Pension. The combined contribution rate is 18.5 percent of earnings (16 percent for the NDC and 2.5 percent for the Premium Pension).

The Premium Pension accounts are privately managed, under public supervision, and can be invested in almost 700 domestic and foreign mutual funds. Earnings are reported on an annual basis. Recordkeeping and investing on behalf of licensed pension funds is carried out by the Premium Pension Agency, a regulatory authority. Participants may choose to have the government manage their premium account balances instead of a private manager. For those who fail to make any selection, there is a government managed default fund.

Relatively low administrative costs are mandated. Initial surveys indicate that many participants find the system to be complicated and feel that they are inadequately informed about the basics of the new system.

Japan

Japan has a two-tiered system. The first tier is a flat-rate benefit for all working age residents and citizens living abroad. The second tier is an earnings-related benefit. Employees and employers contribute to both tiers but the employers can reduce their contribution to the second tier by contracting out part of that pension. The first tier full benefit is payable at age 65 (with an actuarially reduced benefit payable at age 60), but a full benefit under the second tier may be payable at age 60.

The finances of the public pension system have rapidly deteriorated since 1999. The government is now considering a package of reforms to the pension system that would significantly increase the tax contributions incrementally through 2017. Simultaneously, benefits as a percentage of average salary would be gradually reduced. The government is also proposing to increase its share of the national pension program expenditures. At the same time, public skepticism in the viability of the pension system is growing and, as recent news reports indicate, many workers are not paying the required mandatory premiums into the system.

Germany

In Germany, retirement income comes from a variety of sources. The public pension system operates on a pay-as-you-go basis and is financed by a 19.1 percent contribution rate split evenly between employers and employees. There are also employer-sponsored pensions which offer earnings-related benefits, but only to a relatively small portion of retirees. A system of voluntary individual accounts, known as *Reister* pensions, was introduced in 2001 to provide additional retirement income. These savings accounts can be arranged either individually or through an employer. Available evidence indicates that demand for them has remained low and the government is considering steps to encourage participation.

Fiscal pressures resulting from an aging population, combined with relatively early effective retirement ages and high replacement rates, prompted a series of pension reforms in 1992, 1999, and, most recently, in 2004. This year, the government enacted two reform packages designed to address an estimated $10 billion shortfall in 2004. The first of these reduced benefits by freezing the usual annual benefit increase and delayed the payment schedule of benefits from April

2004. The second reform involved changing the way that pensions are calculated. Effective January 1, 2005, a “sustainability factor” will be introduced into the pension benefit formula that will link the level of retirement benefits to the size of the workforce relative to the number of retirees. As the “dependency ratio” rises, benefits are expected to fall from 53 percent of pre-retirement income to 46 percent by 2020. Additional changes enacted in the March 2004 reform package include an increase in the statutory age for early retirement from 60 to 63 by 2008 and the elimination of credit years for time spent in school.

Lessons Learned

This brief review illustrates the diversity of responses to the challenge presented by global aging. We can learn valuable lessons from international experience. And I believe the American people want us to learn these lessons. A recent poll by the Opinion Research Corporation reported that 60 percent of working age adults are not confident that Social Security will still exist when they retire. The 25 to 44 year old group was the most pessimistic with 73 percent doubters. Even 36 percent of near-retirees (those 55 to 64) were not confident that Social Security will be there when they retire.

By looking at other countries that have made or are making reforms to their retirement systems, we can use their experience to improve decisions and avoid some of those same problems.

The first lesson to learn is that Social Security reforms are inevitable. Because of global aging, reforming social security systems is being discussed throughout the world. As President Kennedy said in 1961, “The Social Security program plays an important part in providing for families, children, and older persons in times of stress. But it cannot remain static. Changes in our population, in our working habits, and in our standard of living require constant revision.”

The second lesson is the importance of acting sooner, rather than later, in beginning to implement reforms. The experience of other countries shows us that strengthening social security programs takes a long time.

The importance of early action is also highlighted by the experience of continental Europe and Japan. Rising life expectancy, falling birthrates, and a decline in the worker to retiree ratio have led to the need for drastic action to achieve sustainable public retirement systems, including significant tax increases and benefit reductions. By choosing to act sooner to strengthen our Social Security system, we will be able to select from a broader array of options and phase in any changes more gradually.

A third lesson is that, if personal accounts are established as part of a plan to strengthen Social Security, it is important to keep administrative costs in check. Some countries, such as the United Kingdom and Chile, have experienced relatively high costs in administering the accounts, whereas Sweden's process appears to have been more successful in limiting administrative costs.

In the United States, we have probably the world's best example of a government sponsored personal account system, the federal government's Thrift Savings Plan. It offers five diversified investment choices with fees that are lower than 1/10 of one percent of assets.

Another lesson we have learned from looking at the experience of other countries is the need to improve the public's general financial literacy. Legislation passed by the Congress and signed by President Bush last December created the Financial Literacy and Education Commission, of which Commissioner Barnhart is a member. The Social Security Administration has been active in promoting savings and financial literacy. We have sponsored the "Save for Your Future" campaign with American Savings Educational Council to promote savings.

A final lesson is that it is very important to help people understand the need for reform. In many countries that I have discussed, reforms have been bipartisan and ongoing, no matter what political party is in power.

Conclusion

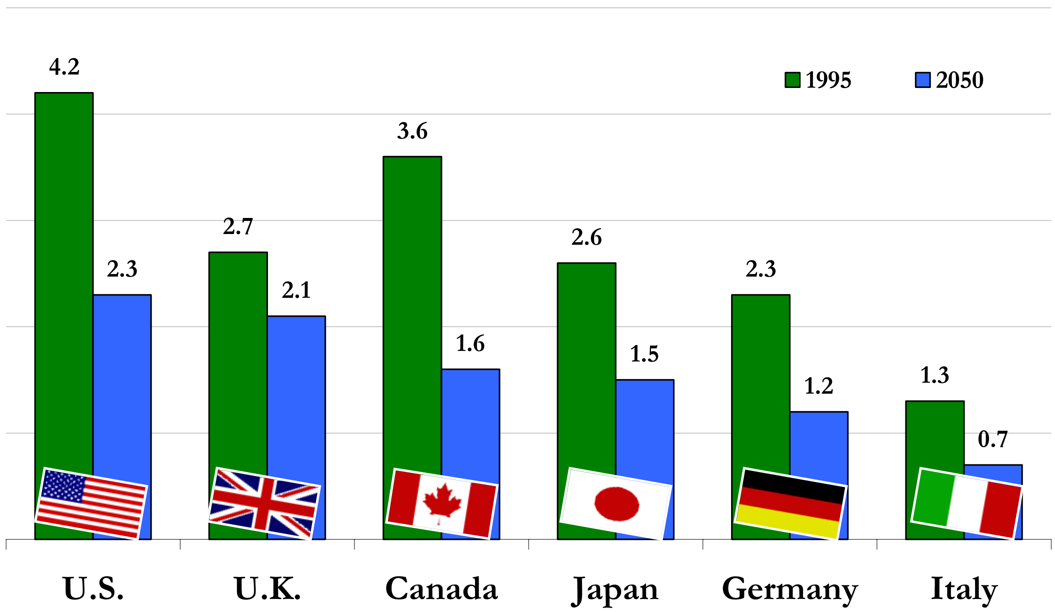
We live in an era defined by many challenges, but few are as certain as global aging and as likely to have such a large and enduring effect on the shape of national economies and the world order.

The developed and developing worlds must work together to engage this challenge constructively. Putting off strengthening of our Social Security system will limit the possible choices available to us. By taking action sooner, the changes to the program can be smaller and less abrupt. Further, the sooner action is taken, the sooner confidence can be restored to the Social Security program.

In conclusion, let me say we have much in common with many countries around the world as we face similar demographic challenges. It is important to learn as much as we can from their experiences.

Mr. Chairman, I again commend you for holding this hearing and for your efforts in keeping this issue before the public and, especially, for your very strong leadership in the bipartisan effort to strengthen Social Security. I will be happy to answer any questions you or the other Members have.

Ratio Of Workers To Retirees Is Falling Rapidly



Source: IMF (1996)